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NOVEMBER 2010

Once in a lifetime

CUSTOMER VALUE IN FINANCIAL SERVICES

Before the financial crisis, banks could fund their lending from either the wholesale market or retail (and commercial) deposits. When the wholesale source dried up, banks had to rediscover how to minimise the cost of funding from retail deposits alone. In Frontier's experience, this requires a deep understanding of the economics of savings products, and in particular how to maximise customer lifetime value.

Long ago, the "traditional" model of banking was said to follow the 3-6-3 rule: a bank manager could take deposits at 3%, lend at 6% and be on the golf course by 3 o'clock. It was a simpler world in which deposits and lending were directly linked: banks would not take in more than they could lend, nor lend more than they received.

This model broke down with the rise of securitisation and wholesale funding. Banks started to lend more, and fund this either from the wholesale markets or from their retail deposits, depending on which they had to pay more for. Some banks, such as Northern Rock in the UK, came to rely heavily on wholesale funding – and suffered equally heavily when the crisis came.

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Figure 1 shows how household lending rapidly outstripped savings between 2000 and 2008. When the financial crisis hit, wholesale funding became much more expensive, and at times dried up altogether. Suddenly, banks had to fill this funding gap by seeking temporary support from the Government, by reducing their lending or by increasing their deposits - hastily reducing the funding gap. But the Government is now keen to reduce its support, while pressing the banks to lend more to businesses. So deposits have become critically important.

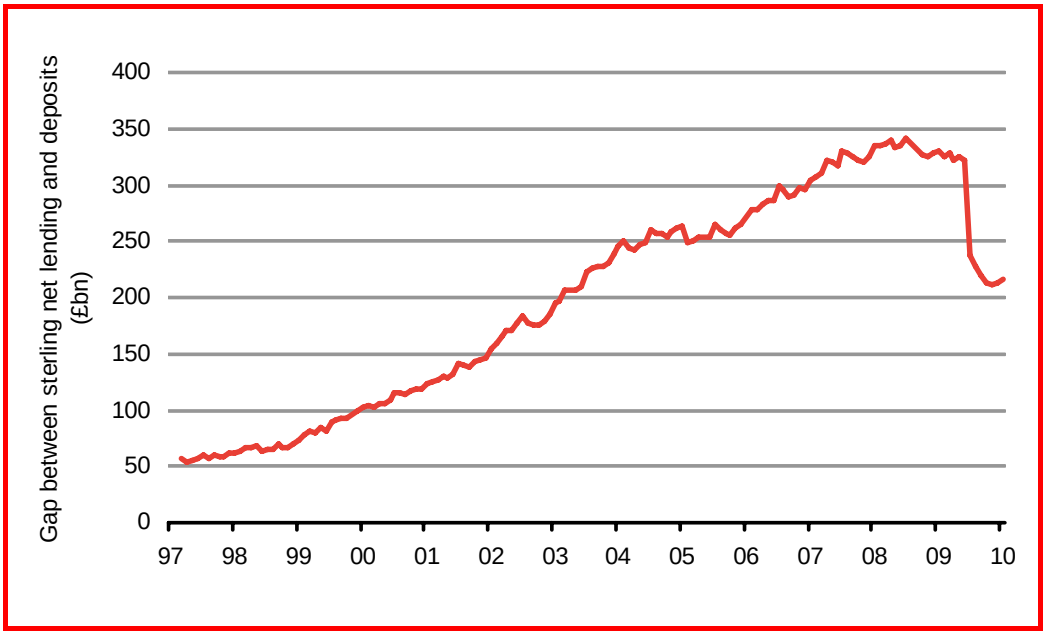

Figure 1: The funding gap between UK household loans and deposits

Source: Bank of England

BACK TO THE FUTURE

In this new-old world, the savings business has become central to a bank's performance. Competition to attract and retain retail deposits has intensified. This, of course, makes it harder to maximise the spread between deposit and lending rates. Many banks have responded to the challenge of meeting funding requirements at lowest cost by daily monitoring of their flows of funds. Accounts, or "products", that attract an excess inflow, perhaps because a competitor's rates have just been cut, need to be closed off quickly. Conversely, if the inflow of deposits into a certain type of account is falling behind target, then a product may need to be repriced to offer the saver a more attractive rate.

But while important, this flow-of-funds management ignores the time dimension to savings products. Pricing products to adjust flows of funds today may not generate the best long-term results. Once customers deposit their savings in a particular account, they may keep them there for a long time. Some may review the market for their savings frequently; others may not do so for years. Whether this loyalty reflects customer satisfaction or customer inertia, it changes the economics of competition.

Traditional methods of measuring the cost of funds, such as average interest income, will often fail to capture the time dimension of new propositions. In markets where there are long-term relationships between customers and suppliers, such as financial services, telecoms and utilities, customer lifetime value (CLTV) models provide valuable insights. These models assess product propositions as investments in the future return from customers.

A DIFFERENT PROPOSITION

For example, suppose a bank wants to increase its retention of deposits from a particular product. The bank currently uses a front/back pricing model: it acquires customers with temporary bonus rates, before reverting to a lower standard rate. It is considering a new loyalty scheme, giving an annual bonus of vouchers for a customer's favourite high street store. This will obviously raise costs per customer, but by improving retention may reduce the need for costly acquisition pricing. Figure 2 below sets out the costs and effects of this example for a cohort of customers acquired in year 1.

The loyalty scheme would cost £700,000 in the first year; more than the current arrangements, which cost £500,000. But by the second year, the effect of increased retention means the bank holds more deposits paying the standard rate and generates higher profits from the cohort. By the end of year 3, the scheme is positive in cash terms, as later profits more than offset upfront costs.

Over the next five years, the scheme could add a quarter to the value of the cohort acquired in year 1 (at a 10% discount rate). The bank could return this increase in value to shareholders, or to customers (helping it to win more deposits). For example, the bank could increase its first-year bonus interest rate by 30 basis points, compared with its current product offering, enhancing its competitive position.

	Current product	Loyalty scheme
Cost of loyalty scheme		**0.2% of balances**
Balances retained per year	**75%**	**85%**
Balances retained at bonus expiry	**50%**	**65%**
Standard interest rate	**0.5%**	
Bonus interest rate	**2.5%**	
Wholesale interest rate (cost of funds)	**2.0%**	

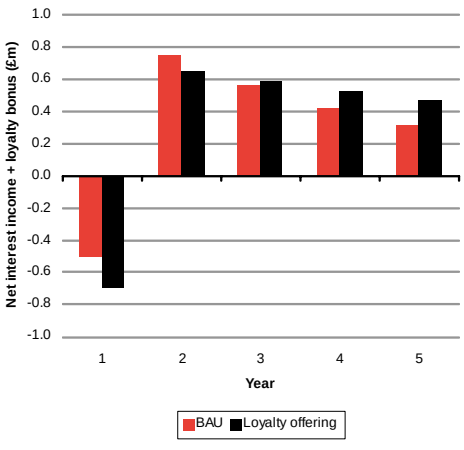

Figure 2: Illustration for a £100m cohort in year 1 comparing a loyalty offering with current product

However, it is not that easy for bank executives to come to such a decision. For a start, the benefits from the loyalty scheme come from changes in customer behaviour, which are difficult to predict; managers must put their faith in forecasts of retention rather than real-time evidence of fund flows. Secondly, where staff are paid on the basis of current performance measures, incentives within the bank may not align with CLTV, making it personally unattractive to managers to invest in trying to increase retention.

But while challenging, CLTV models can and should be used systematically within a savings business. Ignoring lifetime value distorts business decisions. As a first step, CLTV analysis can be introduced in parallel to normal business decision processes to test scenarios for customer and competitor responses. This will help flush out decisions where the business is trading off long-term value for short-term gain.

CLTV modelling then helps to rephrase questions in more helpful ways. The example above shows that the bank needs either to retain 35% of deposits at bonus expiry, or to see customer churn fall below 10% (or some combination of the two), for the proposition to at least pay back within five years. This gives a hypothesis for the management team to debate and test. And a good way to build confidence further is to introduce a programme of testing and learning. This can help bound predictions of customer behaviour. Pilots can be used, and then scaled up, as confidence in the predictions grows. With parallel CLTV processes and experience from such pilots, businesses can start to invest in propositions that enhance long-term value, and gain more confidence to forgo projects that only offer short-term returns.

To embed CLTV, incentives and rewards need to be aligned with long-term performance. This is particularly critical for new banks, trying to build up a viable share in the savings market. They have to invest new capital to cover these early-year losses, whereas an existing bank may finance these costs out of current income from other customers. New banks (and their investors) need to work within the CLTV framework to maximise the return on investment.

CONCLUSION

In the competition for deposits, the banks that will have the biggest advantage are those that can manage costs over customer lifetimes. Measuring CLTV is difficult. But having the right insights, incentives and trial systems in place can provide the framework.

CONTACT	**Antti Lemberg** antti.lemberg@frontier-economics.com
	Paul Cullum paul.cullum@frontier-economics.com
	Frontier Economics Ltd
	FRONTIER ECONOMICS EUROPE BRUSSELS | COLOGNE | LONDON | MADRID
	www.frontier-economics.com